Criteria for Evaluating Competitive Markets

Services	Phase I	Phase II	Phase III
HiCap Special Access	100 DS1 equivalent collocated cross connections [2]	Competitors offering[3] service to 25% of market	Competitors offering service to 75% of market
Direct Trunked Transport	100 DS1 equivalent collocated cross connections	Competitors offering service to 25% of market	Competitors offering service to 75% of market
Tandem Switched Transport	100 DS1 equivalent collocated cross connections	Competitors offering service to 25% of market	Competitors offering service to 75% of market
Remaining Special Access	Competitors offering service to 25% of market	Competitors offering service to 25% of market	Competitors offering service to 75% of market
ML Business	Negotiated or State approved agreements or SGATs for UNEs, resale and terminating compensation, interim # portability available, 100 UNE Loops in service	Competitors offering service to 25% of market	Competitors offering service to 75% of market
SL Business and Residence	Negotiated or State approved agreements or SGATs for UNEs, resale and terminating compensation, interim # portability available, 100 SL UNE Loops in service	Competitors offering service to 25% of market	Competitors offering service to 75% of market
Price Cap X-Factor	50% of ILEC total interstate revenue under Phase I, II or III	25% or more of ILEC total interstate revenue in Phase II or III	Not Applicable
Interexchange Corridor	Not Applicable	Not Applicable	Immediately, market is substantially competitive
Interexchange (IntraLATA)	Not Applicable	Not Applicable	When intraLATA presubscription is available
Directory Assistance	Not Applicable	Not Applicable	When an alternative provider offers service

[2] This criteria is similar to those required before ILECs are permitted to offer volume and term contracts for switched transport services. Consistent with these prior criteria, in a State with few density zone 1 offices, the criteria would be met when the number of DS1 equivalent cross connects in service to collocated cages averages at least 25 per density zone 1 office in that State.

[3] "Offering" means competitor's have demonstrated the capability to provide service.

Regulatory Flexibility Proposed

Services	Phase I	Phase II	Phase III
HiCap Special Access	Respond to Requests for Proposals	Contract rates Increase upper service band limits to 10% Growth option with V&T	Services removed from Price Cap regulation
Direct Trunked Transport	Respond to Requests for Proposals Target TIC reductions to TIC in collocated WCs	Contract rates Increase upper service band limits to 10% Growth option with V&T	Services removed from Price Cap regulation
Tandem Switched Transport	Respond to Requests for Proposals Target TIC reductions to TIC in collocated WCs	Contract rates Increase upper service band limits to 10% Growth option with V&T	Services removed from Price Cap regulation
Remaining Special Access	Respond to Requests for Proposals	Contract rates Increase upper service band limits to 10% Growth option with V&T	Services removed from Price Cap regulation
ML Business	Deaverage ML PICCs by UNE zone and class of customer (e.g., MLB, Res.) V&T PICC pricing Deaverage ML SLC by UNE zone Deaverage overflow in ML Bus O/T MOU by UNE zone Promotional offerings	Contract pricing Growth option with V&T plans Deaverage MOU rates by UNE zone	Services removed from Price Cap regulation
SL Business and Residence	Deaverage PICCs by UNE zone and class of customer (e.g., Bus., Res.) V&T PICC pricing Promotional offerings	Contract pricing Deaverage MOU rates by UNE zone and class of customer Deaverage SLCs by UNE zone	Services removed from Price Cap regulation
Price Cap X-Factor	CPD eliminated	Reduce X-Factor corresponding to the % of revenue in Phase II and III (e.g., 40% in Phase II&III then 40% reduction in X) X-Factor floor may be GDP-PI	Not Applicable
Interexchange Corridor	Not Applicable	Not Applicable	Removed from price regulation
Interexchange (IntraLATA)	Not Applicable	Not Applicable	Removed from price regulation
Directory Assistance	Not Applicable	Not Applicable	Removed from price regulation

CHARACTERISTICS OF A COMPETITIVE ACCESS SERVICES MARKET

The characteristics of competitive access markets vary, with the pace of competition developing differently by geographic area and type of service. The historical pattern for competitive entry has generally been for competitors to target first the high capacity special access markets, then the market for switched transport services, and then services for very large multiline business (MLB) customers. Generally, competitors start to target the residential consumer market only after these more lucrative markets have been entered.

The passage of the Telecommunications Act of 1996 and the Commission's recent actions have dramatically altered the market environment for interstate access services and accelerated the development of competition in these markets. The requirement for ILECs to provide unbundled network elements (UNEs) enables competitors to enter new markets with minimal investment. Competitors no longer have to incur the time and expense to build-out new networks. Instead, they may compete with the ILECs by using UNEs provided by the ILECs or reselling the ILECs' services with, or without, their own networks. These requirements support competitive entry into the local exchange market even more than such entry was facilitated in the long distance market, where there were no requirements for discounted resale or UNEs.

The characteristics of the access marketplace are such that the regulatory framework must be more adaptable to these competitive developments. Competition has increased the need for additional pricing flexibility, structural flexibility and streamlined regulation. The goal should be an administratively simple process that can quickly assess competitive developments, easily determine how competitive a market is, and enable the movement of services, groupings of services, or geographic areas out from under price cap regulation.

An administratively simple process is called for because, unlike the long distance market that dealt with one dominant carrier serving a nationwide market, the price cap ILECs provide a range of services in 50 States and 163 LATAs and, in some cases, more than one ILEC provides services in the same State and LATA. In addition, the assessment of competition in specific geographic markets may require demonstrations on a service specific basis, such as by special access, high capacity services, multiline business customer services or residential customer services. Therefore, it is conceivable that the Commission will be required to review more than 2900 requests for pricing flexibility (163 LATAs times 6 market segments times 3 phases).[4] An administratively simple, streamlined process is essential for both the FCC and ILECs to efficiently evaluate these requests.

DETERMINATION OF THE EXTENT OF COMPETITION

There are two important variables for determining the competitive nature of the access marketplace. These are the "market areas" where services are offered, and the type of "access service" offered.

The ILEC seeking flexibility is in the best position to evaluate how competition is evolving and should be allowed to self-define a market area, subject to the limitation that it is no smaller than a LATA. Competition may evolve differently for different services or in different areas. The ILEC should not be limited to a single definition. Such discretion is restrained because if an ILEC selects a larger area it must meet the criteria for that entire area. Conversely, if it selects a smaller area, it must make repeated showings for additional areas. The end result is that the ILEC will select the market area size that matches the actual pattern of competition.

The analysis of competitive markets must also recognize the differences between non-traffic sensitive services and rates, such as special access, direct trunked transport, PICCs and EUCLs, and traffic sensitive services and rates, such as switched access services provided for multiline business and residential customers.

Special access and **direct trunked transport** services are made up of facilities dedicated to the use of a carrier and/or end user customer. These services connect two

[4] This estimate is based on an assumption that all ILECs request relief based on a market area of a LATA. A different assumption would result in different number of reviews. Furthermore, the Commission has indicated that it anticipates that many of the ILECs' services will be subject to competition by the year 2001. Therefore, over the next three years the Commission may receive a number of such request by the price cap ILECs.

points within a LATA. The factors that foster growth of competition and competitive behavior are fully developed in this market, particularly for the high capacity (DS3 and DS1) transport services. Competition for some of these facilities, e.g., POP-to-POP or large end user-to-POP, has existed for a long time and competitors have already installed significant fiber networks in primary and secondary markets. In addition, collocation and interconnection have enhanced the ability of such competitors to compete effectively with ILECs. And the end user customers of these services are highly sophisticated with extensive knowledge of the alternative services available. These competitive special access and transport services are fully substitutable for ILEC provided services and can "stand alone."

Switched access services are generally not dedicated to the exclusive use of an interexchange carrier. These services are offered to provide carriers access to their customers through the ILECs' switched network. To some extent, competition for switched access services depends on the development of local exchange competition. Therefore, in evaluating the status of competition for switched access services, the criteria should include a measure of how local exchange competition is developing within a geographic area, which indicates the potential for switched access competition. This is further complicated because at least two distinct classes of end user customers must also be considered. As noted above, local exchange competitors generally target multiline business customers well before they start to offer services to single line business and residential customers.

The proposal set forth below recognizes the importance of establishing different criteria and timing for evaluating the competitive state of special access and switched access services and the pricing flexibility provided. It defines specific criteria for such an assessment.

The determination of when an ILEC's services in a specific market are subject to sufficient competition and accorded relaxed regulation is made by evaluating the following criteria. The triggers assessed represent a higher potential for, or a more intense level of, competition and reduced market power for the ILEC.

These criteria are:

1. Market entry -- Barriers Removed
2. Supply availability -- Competitive Presence
    - Are there alternative sources of supply in the market?
3. Demand for alternative services -- Demand Responsiveness
    - Are the services offered by competitors substitutable among and between customers?
    - Can users of services readily move from one provider to another without difficulty?

Shown below are the details for assessing a market's competitive status using the criteria for supply availability and demand for alternative services.

MARKET AREA COMPETITIVE CLASSIFICATIONS

There are three phases of regulation envisioned for competitive markets that align the extent of competition in a market area with the pricing flexibility provided to the ILECs.

The classifications of these markets are:

Phase I -- competitive presence

Defined as a State satisfying the criteria for removal of barriers to entry and supply availability for a service or group of services.

In the special access and transport market,

- there are interstate collocation facilities in service, and
- competitors have obtained cross connections to their collocated facilities.

In the switched access market,

- there are negotiated or State approved agreements or Statements of Generally Available Terms (SGATs) for;
    - unbundled network elements (UNEs),
    - transport and termination of traffic, and

- discounts for resold services;
- interim number portability is available, and
- competitors have 100 UNE loops in service.

Phase II -- increased competition

This market area meets the criteria of supply availability and demand responsiveness when competitors **have demonstrated the capability to provide** service through the use of collocation in wire centers (WCs), UNEs or their own facilities in an area that consists of **25%** of the market.

Phase III -- substantial competition

This market area meets the criteria of supply availability and demand responsiveness when competitors **have demonstrated the capability to provide** service through the use of collocation in WCs, UNEs or their own facilities in an area that consists of **75%** of the market.

This proposal defines markets and relates the degree of regulatory flexibility to the degree of competition. That is, an area could be classified as Phase II and subject to increased competition for MLB services, while high capacity special access and direct trunked transport services in the same area have been classified as Phase III and found to be subject to substantial competition and, therefore, removed from price cap regulation.

DETAILED DESCRIPTION

PROPOSAL FOR PHASE I AREAS -- competitive presence

In a Phase I State area, there is a competitive presence in a portion of the territory served by the ILEC. A competitive presence is defined as a competitor that has **demonstrated the capability to provide service to end users through the use of unbundled loops, cross connections to its collocated facilities or its own facilities.** In this area, competitors may obtain UNEs at negotiated rates or rates ordered by State commissions. Competitors may also exchange traffic with the ILEC at negotiated rates or rates ordered by State commissions for the transport and termination of such traffic. And resold services are available to competitors at negotiated or State approved discounts. In addition, interim number portability arrangements are available.

The *pricing flexibility* provided in this State should be consistent with the criteria satisfied. The criteria include the use of UNE loops and cross connections to collocated facilities. Both are non-traffic sensitive in nature, therefore, the primary flexibility provided are for services with non-traffic sensitive charges, such as PICCs, EUCLs and special access and direct trunked transport services.

When the ILEC meets the criteria for **high capacity special access and direct trunked transport of 100 DS1 equivalent collocated cross connections**, then the ILEC should be permitted to respond to customer (end users, carriers, etc.) initiated requests for proposals (RFPs)[5] with customer specific pricing for packages of services. The ILEC would be required to make such offers available to similarly-situated customers under substantially similar circumstances. Customers have been issuing RFPs, and receiving bids, for their transport and high capacity services for some time. And consumers are best served by allowing ILECs to participate in the bidding process.

[5] Since some of the cost related to tandem switching will still be in transition from the TIC, such an RFP should be required to recognize this fact by including annual adjustments to the RFP price for the tandem switched rate until the transition is completed. In the alternative, tandem switching could be excluded from such RFPs until the tandem switch cost have been fully transitioned.

When the ILEC meets the criteria for the **MLB market by having negotiated or State approved agreement or SGAT rates for UNEs, resale and terminating compensation, availability of interim number portability and 100 UNE loops in service**, then it should be permitted to selectively lower its PICCs by State approved pricing zones for UNEs and offer term and volume pricing for PICCs.[6] This consists of the ability to selectively deaverage prices by targeting future price cap reductions to the high density UNE zones, while retaining revenue neutrality for the service as a whole. This would permit the ILEC to charge higher prices in low density areas and lower prices in high density areas. Such price reductions should be allowed to occur on a selective basis, e.g., in certain offices designated as high density areas, but not be required in all high density areas. In addition, the PICC prices should be allowed to vary by class of service by targeting reductions to MLB PICCs. The ILEC should also be permitted to similarly geographically deaverage its MLB subscriber line charge (SLC).

Some additional flexibilities are also proposed in Phase I for traffic sensitive rates that include non-traffic sensitive costs. An ILEC that meets the criteria of 100 DS1 equivalent cross connections to collocated facilities would be permitted to further target required price cap reductions to reduce, or eliminate, the residual per minute of use (MOU) TIC rate for MOUs that originate from, or terminate to, end user customers served by WCs that have competitive collocation facilities in service. And ILECs that meet the criteria for flexibility associated with MLB lines should also be permitted to deaverage its originating and terminating MOU rates for traffic from these lines to the extent that there is a difference between the originating and terminating rate. Such a difference in originating and terminating rates indicates that certain non-traffic sensitive costs, e.g., common line or residual TIC, have overflowed from other flat rated rate elements into per minute of use charges.

[6] The Commission should also provide the ILECs with the flexibility to respond with contract based rates to RFPs for the services supported by the universal service fund for the schools and libraries. In such a case, the universal service support would only compensate the ILEC for the difference between the price paid by the school or library and the bid price of the ILEC, and not for the difference between the bid price and the ILEC's tariffed rates.

The ILECs should also be permitted to make promotional offerings with new restructured services.[7] Such offerings could include; special discounted introductory rates for a specified period, special bundled offerings where the customer signs up for the new service and is given another service/product (or gift) at a discount, or waiver of nonrecurring or recurring charges for the new service. These promotional offerings will be for a limited period and provide the benefit of stimulating latent consumer demand for such services.

Finally, the price cap consumer productivity dividend (CPD) should be eliminated when 50% of the ILEC's interstate revenues are offered under Phase I, II or III regulations. For example, if 10% of the ILEC's interstate revenues are in Phase III, 25% in Phase II and 15% in Phase I, which equals 50% in Phase I, II and III, then the CPD should be eliminated for that ILEC. The CPD was originally included as part of the price cap X-Factor to ensure that the initial efficiency gains resulting from moving to incentive regulation was flowed to customers. In its recent price cap order, however, the Commission estimated historical productivity based on actual results under price cap regulation. The CPD is an add-on that assumes productivity growth above historical levels. For a company that opens its markets to competition, this is an unwarranted assumption.

PROPOSAL FOR PHASE II AREAS -- increased competition

In Phase II areas, competitors have **demonstrated the capability to provide service** to a significant portion of the market.

Before an ILEC can transition its **single line business and residence** services to Phase II regulation, it must

- establish that competitors have **demonstrated the capability to provide service to 25%** of the ILEC's service market by showing where competitors have collocated, provided service through the use of UNEs, or offer residential

[7] The ILECs should be permitted to offer new services free of price regulation as discussed below.

or single line business services over their own network facilities in the geographic area served by an ILEC WC in the market.[8]

Before an ILEC can transition its **special access, direct trunked transport** or **multiline business** services to Phase II regulation, it must:

- establish that competitors have **demonstrated the capability to provide service to 25%** of the ILEC's service market by showing where competitors have collocated, provided service through the use of UNEs or have known network facilities in service in the geographic area served by an ILEC WC in the market.

This process would require the ILEC to classify WCs as competitive or non-competitive using the above methodology. Then the ILEC would calculate the amount of its service market, by demand or revenue, served in competitive WCs and determine what percentage this is of the ILEC's total service market in the LATA or State where the showing is being made.[9]

For example, if competitors have collocated, obtained UNEs for DS1 and DS3 services and/or have their own network facilities in WCs that equal **25%** of the ILECs total **high capacity interstate DS1 and DS3** revenues in a LATA, then the ILEC has met the criteria for Phase II regulation of these services in that LATA.

A similar showing for **MLB services** would be made as follows. Suppose an ILEC has 1,000 MLB lines in service in a LATA. And competitors have collocated in 10 WCs that serve 400 MLB lines and other competitors have obtained UNE loops in an additional 5 WCs serving 100 MLB lines. In addition, a competitor has developed its own network in areas served by another 2 ILEC WCs that have 50 MLB lines in service. Therefore, competitors have demonstrated the capability to provide service to a market area that includes 550 of the MLB lines that the ILEC provides service to in the LATA. This equals

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[8] This process recognizes that competitors may be less likely to offer services to the more dispersed residential and single line business markets on their own facilities then they will to the more concentrated MLB, special access and direct trunked transport markets.

[9] The metric criteria for Phase I, i.e., 100 DS1 cross connects or UNE loops, are not a prerequisite for transitioning to Phase II.

55% of the ILEC's MLB market (550/1,000). In this case, the MLB market in this LATA would be classified as a Phase II market.

MLB Lines		**Non- Competitive**	**Competitive**
In non-competitive WCs		450 lines	
In 10 collocated WCs			400 lines
In 5 WCs with UNE loops			100 lines
In 5 WCs with competitive networks			50 lines
Sub Total		450 lines	550 lines
Total Lines	1,000 lines		
Percentage Competitive	**55%** (550/1,000)		

Once the ILEC satisfies the criteria for Phase II regulation, then it should be provided the *flexibility* to offer its services through contract pricing subject to streamlined tariff filings and deaverage its prices by State approved UNE zones and by class of customer, such as multiline business, single line business, residence, etc.

The ability to offer contracts permits the ILEC to **initiate the contract offer** to a customer versus Phase I's flexibility wherein the ILEC may only **respond** to a customer's request for proposals (RFPs). Contract offers would include the provision of services under volume, term and growth discount plans, and customer specific pricing of packages of services, etc. The ILEC would also be required to make such contracts available to similarly-situated customers under substantially similar circumstances.

In addition, once 25%, or more, of the ILEC's total interstate services revenue is offered under Phase II or III regulations, then its price cap X-Factor should be reduced by a corresponding percentage. For example, if 20% of the ILEC's interstate revenue is offered under Phase II and 15% is offered under Phase III regulations, then there would be a 35% reduction in the X-Factor for all of the ILEC's price cap regulated services. As a higher percentage of the ILEC's revenue moves to Phase II and III regulations, then correspondingly higher reductions would be taken in the X-Factor in future years.

Since the ILEC's output growth in Phase II and III market areas will immediately slow as competition accelerates, the X-Factor should be reduced to account for the resulting slowing in productivity growth. In his original report in CC Docket 94-1, Dr. Christensen established that there is a relationship between ILEC output growth and TFP growth based on a reduction in economies of density. In the report, Dr. Christensen pointed out that a 1% decline in output growth leads to a .3% to .5% decline in the rate of total factor productivity growth. An X-Factor based on historical performance will be too high to maintain as a significant portion of services reach the competition criteria.

In order to assure customers that real rates will continue to fall and nominal rates will not rise (at least under current economic conditions), the Commission could limit the reduction in the X-Factor to a floor of GDP-PI.

PROPOSAL FOR PHASE III MARKET AREAS -- substantial competition

In Phase III areas, competitors have **demonstrated the capability to provide service** to a significantly larger portion of the market.

The ILEC should be permitted to demonstrate that specific services, such as interexchange service (IX), corridor services and Directory Assistance (DA), should be removed from price cap regulation in specific market areas. For these services, at this stage, market forces act as a price restraint and price regulation only serves to interfere with the competitive market. The ILECs should also be permitted to offer new services free of price regulation. New services, by definition, provide a competitive alternative to existing services and the prices, terms and conditions for such services will be constrained by market forces. Because regulated services cannot be discontinued absent Commission approval, the new services can only succeed to the extent customers find them a superior alternative to existing products. As a result, customers cannot be made worse off by additional new service offerings and regulation will only serve to inhibit such introduction.

Before an ILEC can transition its **single line business and residence** services to Phase III regulation, it must

- establish that competitors have **demonstrated the capability to provide service to 75%** of the ILEC's service market by showing where competitors have collocated, provided service through the use of UNEs, or offer residential or single line business services over their own network facilities in the geographic area served by an ILEC WC in the market.

Before an ILEC can transition its **special access, direct trunked transport** or **multiline business** services to Phase III regulation, it must

- establish that competitors have **demonstrated the capability to provide service to 75%** of the ILEC's service market by showing where competitors have collocated, provided service through the use of UNEs or have known network facilities in service in the geographic area served by an ILEC WC in the market.

This process is similar to Phase II. However, the hurdles are set higher to demonstrate the increased level of competition in the market.[10]

Once the ILEC satisfies the criteria for Phase III regulation for specific services or groups of services, then those services should be removed from price cap regulation and provided under streamlined regulations. Such regulations would permit tariff filings for those services to become effective on one day's notice and presumed lawful without cost support.

MARKET SHARE AND UNIVERSAL SERVICE

Market share loss is not required for a competitive showing nor is it necessary to demonstrate lack of market power.

Reliance on market share is affirmatively harmful when used to force markets to remain price regulated well after competition is present. ILECs incur higher costs and are at a competitive disadvantage when operating under price regulation rather than under market conditions. Initial competitive losses will be for higher margin services and market

[10] The metric criteria for Phase I, i.e., 100 DS1 cross connects or UNE loops, are not a prerequisite for transitioning to Phase III.

segments. Thus, a small market share loss could have a substantial impact on profitability. If the ILECs were still obligated to comply with unique regulatory obligations until they suffer a significant loss of market share, then the resulting competitive market would be skewed with no benefit to consumers. Indeed, it would be unclear whether future market share losses were the result of natural competition or an implicit regulatory allocation of the market. This is in direct contradiction to the requirements of the Act.

In addition, firms with high market share may lack sufficient market power to control prices. This is especially true if, as it is for most ILEC interstate services, there is unconstrained entry and exit for potential competitors. Resale and UNEs provide price competition for downstream customers without the need for sunk costs by competitors. In such a market, historical market share figures are irrelevant.

Furthermore, the FCC has recognized that a market share test was not essential when it declared AT&T a non-dominant carrier. And cable television providers with virtually one hundred percent market share may be removed from cable rate regulation upon the showing of a phone company offering competing video service.

Since the FCC will be considering many requests from ILECs to move services to differing levels of regulation, it will need to rely on a process that may be easily administered and reviewed. Reliance on a market share test would require the FCC to collect additional data from **all** service providers to verify market share estimates.

There also should not be a requirement for the implementation of competitively neutral universal service funding mechanisms as a pre-condition to any phase of regulatory relief. The ILECs have no control over the timing or structure of universal service funding mechanisms that have been adopted. If any party believes that this mandate has not been complied with, it can pursue its judicial remedies. Moreover, implicit funding mechanisms for universal service primarily disadvantage the ILECs because they must charge above-cost rates for certain services, such as toll calls and business services, to support below-cost rates for services such as residential exchange line and State lifeline services. This gives competitors, who do not carry such universal service burdens, the ability to undercut ILEC rates to high-margin customers. Therefore, universal service funding gives no advantage to the ILECs, and reform of universal service should not stand in the way of pricing flexibility or removal of services from price regulation.

SUMMARY

By adopting this proposal, the FCC will be able to attain its goals, foster the development of economic competition, provide the public with the benefits of competition, protect consumers and provide the ILECs with the opportunity to effectively compete in this new market environment.